October 5, 2005

MEMORANDUM

TO: Legislative Finance Committee Members

FROM: Greg Geisler, LFC Fiscal Analyst
Robert Cardon, DFA Budget Analyst

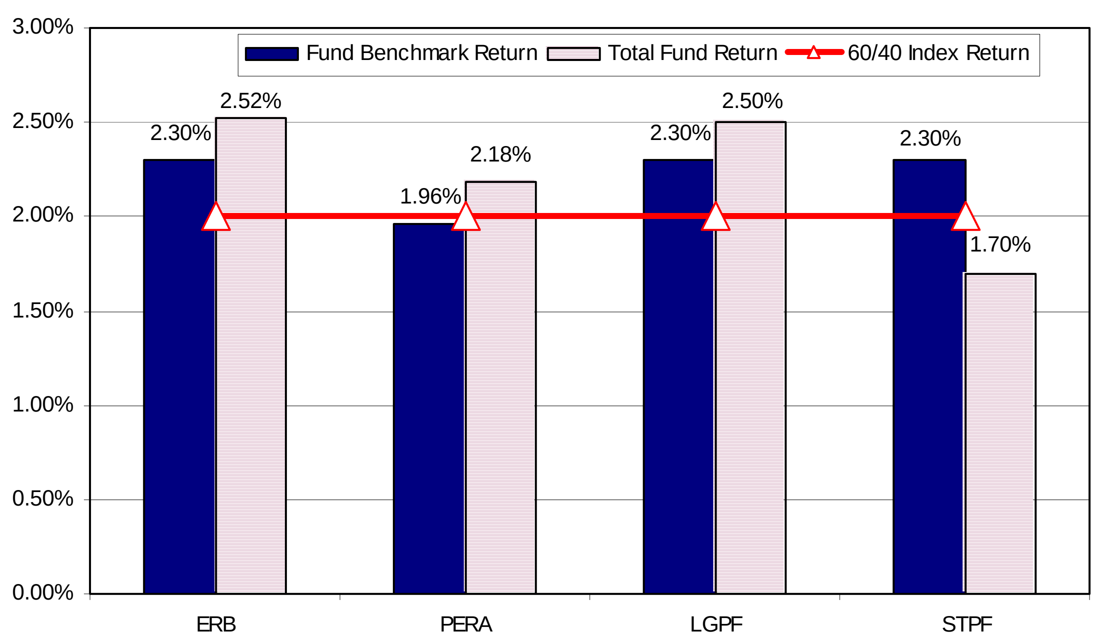
SUBJECT: Report on Investment Performance – FY2005 Fourth Quarter & Annual Report

This is a joint report by the LFC and DFA investment oversight staff, per the Accountability in Government Act. As it covers the end of the fiscal year, this report is expanded in scope and provides more detail on multi-year investment performance.

SUMMARY OF FUND PERFORMANCE

Quarter Ending June 30, 2005. Investment returns for the fourth quarter of the fiscal year were positive after a down third quarter. As shown in Figure 1, total fund investment returns were fairly similar, ranging between 1.7 percent and 2.5 percent. The Educational Retirement Board (ERB) had the best return for the quarter, followed by the Land Grant Permanent Fund (LGPF), Public Employees Retirement Association (PERA) and the Severance Tax Permanent Fund (STPF).

Figure 1
New Mexico Investment Agency Returns, Quarter Ending June 30, 2005



Each of these funds investment performance is compared to a "fund benchmark return.[1]" As

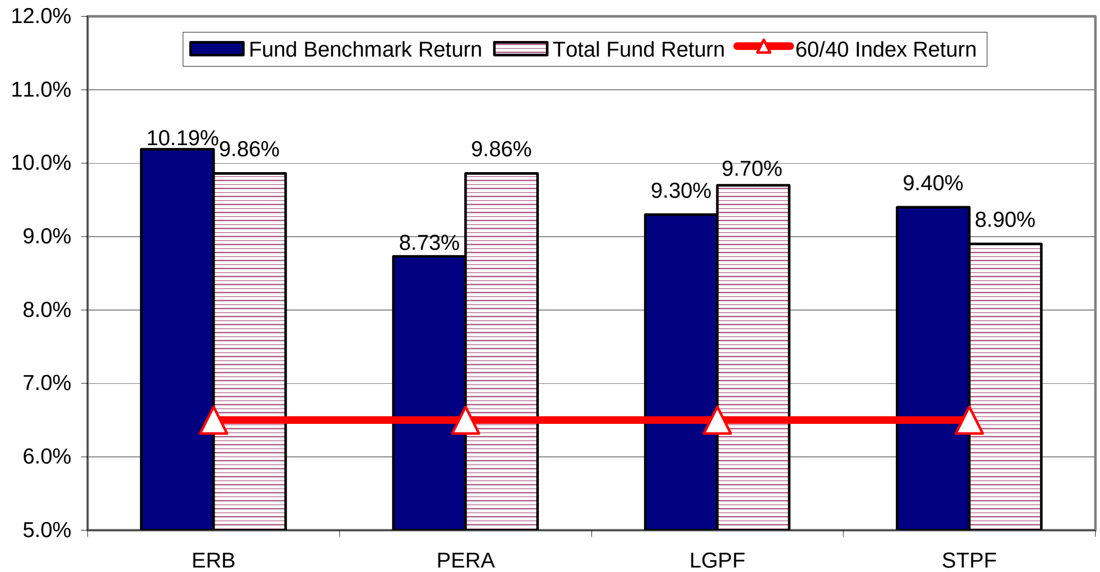
[1] In prior investment reports this was referred to as "internal policy target return."

shown above, for the quarter ERB, PERA and the LGPF performed better than their policy target return, while the STPF lagged their target. Note that the fund benchmark return for each fund is different because they are comprised of a blend of market indices that best match up with their own unique investments.

As each investment agency has an actively managed portfolio, it is expected that their investment returns over the long term should be higher than the return of a balanced portfolio of stocks and bonds invested in low cost index funds that represent the entire market. For comparison purposes, return on a "60/40" portfolio comprised of 60 percent domestic stocks (as measured by the S&P 500) and 40 percent domestic bonds (return measured by Lehman Aggregate) for the quarter was 2 percent, which PERA, LGPF, and ERB all exceeded.

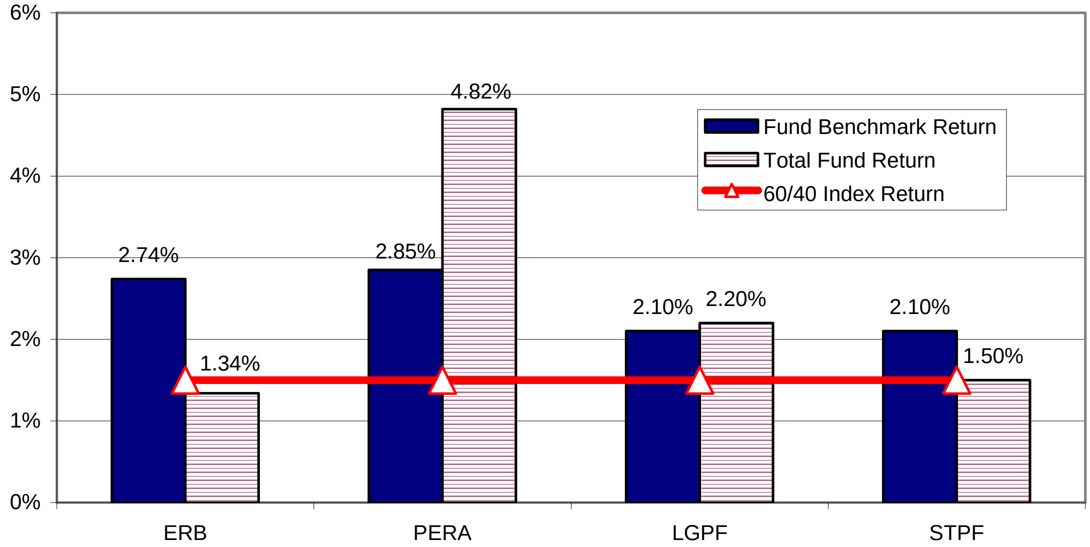
<u>One Year Ending June 30, 2005</u>. For the one-year ending June 30, 2005, investment program returns range from a high of 9.8 percent for PERA and ERB to a low of 8.9 percent for the STPF. PERA and LGPF exceeded their fund benchmarks, with PERA having the best performance versus benchmark by beating the benchmark by 113 basis points. ERB had the largest gap of performance versus benchmark, returning 9.8 percent versus a benchmark of 10.2 percent. For the year, all four funds had returns higher than a 60/40 stock & bond portfolio, which would of returned 6.5 percent for the year ending June 30th.

Figure 2
New Mexico Investment Agency Returns, One Year Ending June 30, 2005



<u>Five Years Ending June 30, 2005</u>. For the five years ending June 30, PERA had the highest return, 4.8 percent, which beat their policy target of 2.8 percent by 197 basis points and topped the 60/40 stock & bond portfolio return of 1.5 percent by 332 basis points. The LGPF and STPF returned 2.2 percent and 1.5 percent respectively, and ERB returned 1.3 percent. PERA and LGPF beat the 60/40 index five year return of 1.5%, STPF equaled the index return, and ERB was 16 basis points below the index.

Figure 3
New Mexico Investment Agency Returns, Five Years Ending June 30, 2005



Ten Years Ending June 30, 2005. For the ten years ending June 30, 2005. PERA had the highest return, 10.3 percent, which beat their policy target of 8.8 percent by 150 basis points and topped the 60/40 stock & bond portfolio return of 8.7 percent by 163 basis points. The LGPF and STPF returned 8.7 percent and 8.3 percent respectively, and ERB returned 8 percent.

Figure 4 New Mexico Investment Agency Returns, Ten Years Ending June 30, 2005

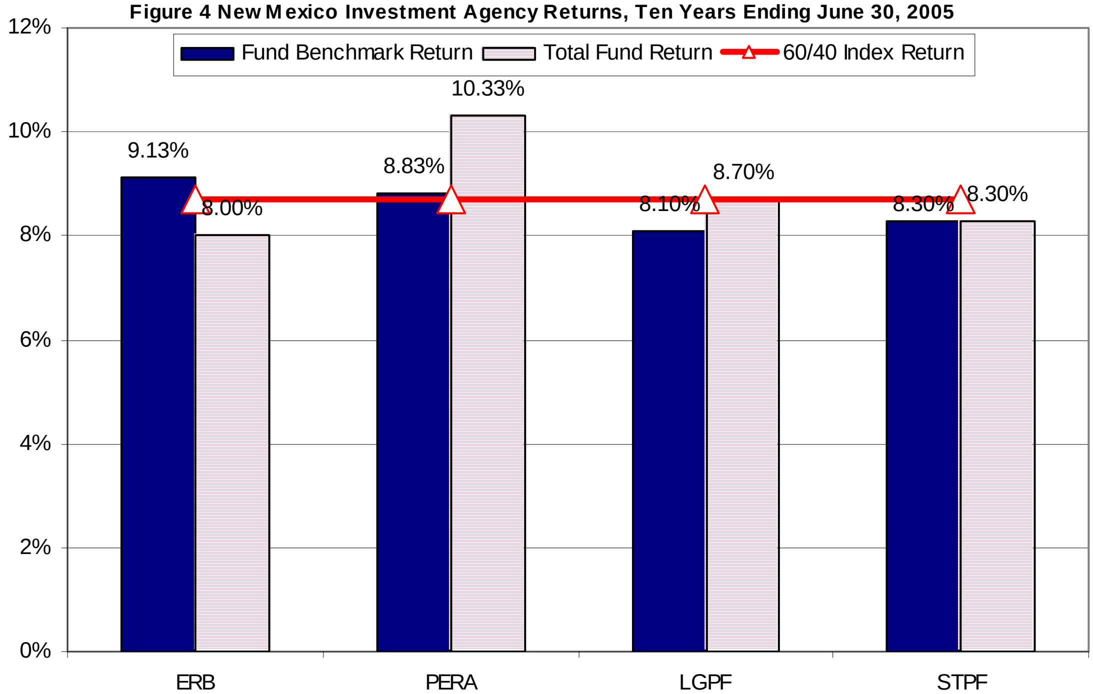
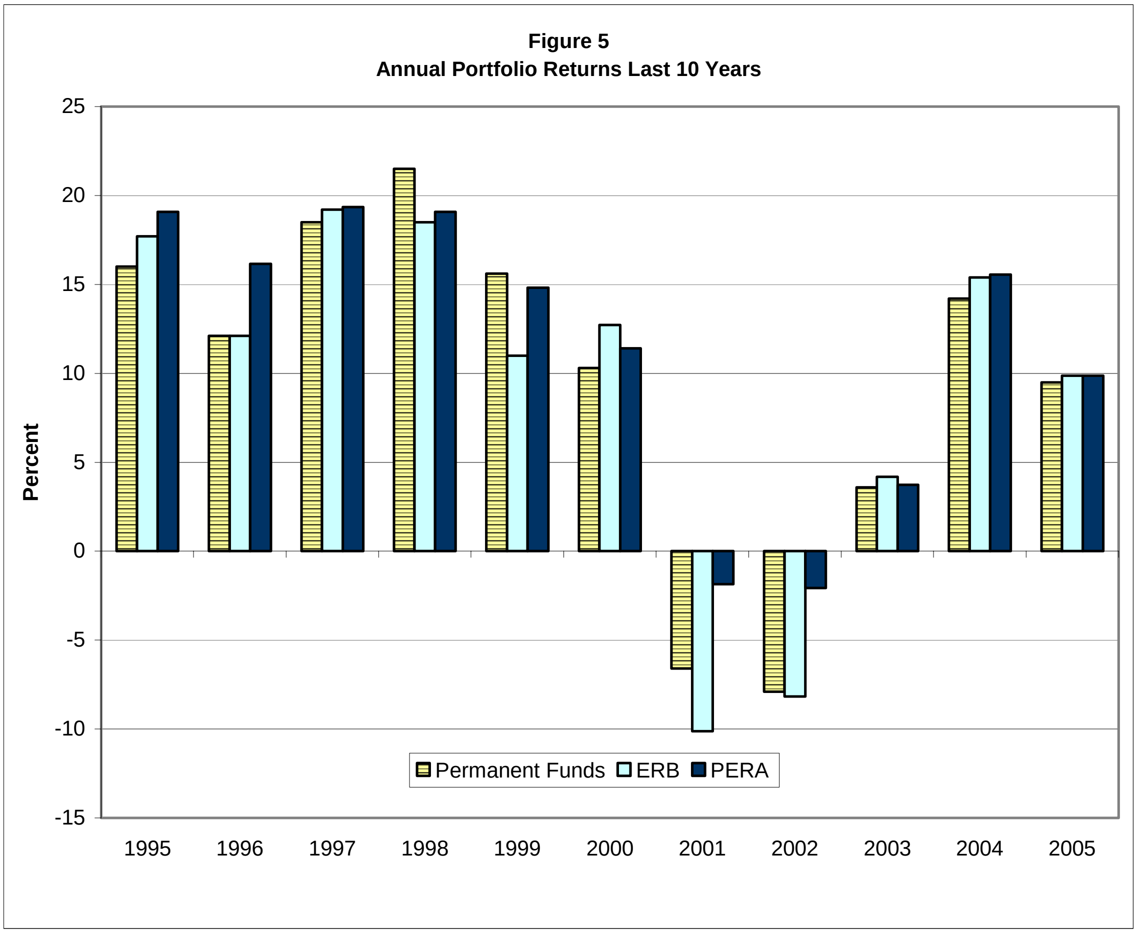


Figure 5 below shows annual returns for the last 10 years. Of particular interest is the impact of the bear market from 2000 to 2002, which led to negative returns for all four funds in FY01 and FY02 and tepid returns in FY03. As a result, total returns for the ten year period for the funds, which range from 8 percent to 10.3 percent, were certainly lower than one might have projected based on the banner returns of the mid to late 1990's. At the same time, the tendency of investment returns to swing above and below the median is illustrated, as well as the tendency for long term returns to end up in the middle range, which in the case of this ten year period was in the 8 to 10 percent range.



FUND ASSET VALUES

Table 1 presents changes in asset values as of June 30th. The quarterly and annual asset value changes in the table reflect both contributions and disbursements to each of these funds in addition to investment returns. The total value of the funds at June 30 was $29.6 billion, up approximately $532 million from total fund value of $29.1 billion at March 31, 2005. Total fund value of all funds is up $2.1 billion from the June 30, 2004 value of $27.4 billion.

Table 1
Current Asset Values (millions)
For Quarter and Year Ending June 30, 2005

Quarterly	ERB	PERA	LGPF	STPF
Current Asset Values (06/30/05)	7,404.2	10,198.3	8,251.1	3,768.8
Value Change (Previous Quarter)	157.6	172.1	167.9	35.1
Percent Change	2.2%	1.7%	2.1%	0.9%

Annual	ERB	PERA	LGPF	STPF
Ending Asset Values (6-30-04)	6,868.7	9,369.8	7,636.4	3,621.2
Value Change (Year Ago)	535.5	828.5	614.7	147.6
Percent Change	7.8%	8.8%	8.0%	4.1%

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The quarter ending June 30, 2005 saw economic growth (GDP) slip from 3.8 percent to 3.3 percent. Market performance continues to reflect worries over oil prices and interest rate uncertainties—the Federal Reserve raised the federal funds target from 2.75 percent to 3.25 percent during the quarter. However, most major equity indices bounced back from last quarter, including the S&P 500 up 1.4 percent, NASDAQ 2.9 percent, Russell 2000 4.3 percent. For international equities, emerging markets continued their strong performance, with the MSCI emerging returning 4.2 percent for the quarter compared to a slight loss in core international MSCI EAFE of -1 percent.

In the fixed income area all major indices bounced back from last quarter. The Lehman Aggregate and US treasuries was up 3 percent and .72 percent respectively. Corporate bonds as measured by the Lehman U.S. credit were up 3.6 percent and high yield bonds gained 2.8 percent

For the 12 months ending June 30, 2005, equity returns were positive, with international return and value stocks having the highest returns. For example, the S&P 500 has returned 6.3 percent for the year compared to the MSCI EAFE which has returned 13.6 percent. In the fixed income area, the LB aggregate returned 6.8 for the past 12 months, high yield bonds returned 10.7 percent, and treasuries returned 2.1 percent.

ASSET ALLOCATION

Currently, all funds are positioned overweight domestic equities and underweight fixed income securities, which has helped fund returns, because equity has out performed fixed income investments. See Table 2 below for asset allocation detail.

Table 2
Fund Asset Allocation Detail, Quarter Ending June 30, 2005

	ERB		PERA		STPF		LFPF	
	Actual	Target	Actual	Target	Actual	Target	Actual	Target
US Equity	46.2%	46.0%	45.5%		59.4%		57.0%	55.0%
REIT	6.0%	5.0%						
Total US Equity	**52.2%**	**51.0%**	**45.5%**	**42.0%**	**59.4%**	**55.0%**	**57.0%**	**55.0%**
International Equity	**21.0%**	**20.0%**	**20.6%**	**18.0%**	**9.7%**	**10.0%**	**9.1%**	**10.0%**
Fixed Income								
U.S. Fixed Income (Core)	18.8%	20.0%	32.1%	37.0%	15.5%	16.0%	24.0%	23.0%
U.S. High Yield Bonds	4.0%	5.0%	1.7%	3.0%	2.9%	3.0%	2.8%	3.0%
TIPS	4.0%	4.0%						
ETI's*					3.0%	1.0%	0.3%	0.0%
CDO's**					0.1%		0.1%	
Total Fixed Income	**26.8%**	**29.0%**	**33.8%**	**40.0%**	**21.5%**	**20.0%**	**27.2%**	**26.0%**
Private Equity* **	N/A	N/A	N/A	N/A	5.9%	12.0%	4.0%	6.0%
Real Estate	N/A	N/A	N/A	N/A	0.0%	3.0%	0.0%	3.0%
Cash Equivalents	0.0%	0.0%	0.0%	0.0%	3.4%	0.0%	2.7%	0.0%
Total Fund %	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

** ETI stands for economically targeted investments*
***Collateralized Debt Obligations*
**** Performance for Venture Capital is reported on a 3 to 4-month lag*

ADDITIONAL DETAIL ON FUND PERFORMANCE FOR QUARTER

Table 3 below shows detailed fund performance for the quarter ending June 30, 2005. For comparison purposes, the table also provides the return for market benchmarks that the investment agencies agreed to in September 2002 (note, these benchmarks are distinct from the individual fund benchmark returns, which are also included in the table). Of note for the quarter is that PERA, STPF, and LGPF beat the Russell 3000 index return for U.S. equity, which was up 2.2 percent for the quarter.

Quarterly Performance

- ERB’s return of 2.52 percent was highest of all four funds and exceeded their fund benchmark return of 2.30 percent by 22 basis points.

- For the quarter, the LGPF and STPF returned 2.5 percent and 1.7 percent respectively. The LGPF beat its fund benchmark return by 20 basis points while the STPF missed its fund policy target by 60 basis points.

- PERA’s return of 2.18 percent beat its fund benchmark return of 1.96 percent by 22 basis points.

Table 3
Fund Performance Detail
Quarter Ended June 30, 2005 (Percent)

Asset Class	Benchmark**	ERB	PERA	LGPF	STPF
U.S. Equity (Russell 3000)	2.24	2.21	2.41	2.40	2.40
Real Estate Investment Trusts (REITS) (DJ Wilshire REIT)	15.22	15.10	n/a	n/a	n/a
U.S. Fixed Income (LB Aggregate)	3.01	2.91	3.07	2.70	2.70
U.S. High Yield Bonds (LB HY)	2.76	1.80	3.26	2.70	2.70
Treasury Inflation-Indexed Securities (TIPS) (LB TIPS)	3.05	2.92	n/a	n/a	n/a
International Equity (MSCI EAFE)	-1.01	-0.05	0.01	-0.90	-0.90
Emerging Markets Equity (MSCI EMF)	4.24	2.95	2.87	2.50	2.50
Private Equity/Venture Capital (Cambridge Venture Capital)	6.30	n/a	n/a	8.70	3.10
Economically Targeted Investments (90 day T-bill)	0.72	n/a	n/a	0.10	1.00
Individual Fund Benchmark Return		2.30	1.96	2.30	2.30
Total Fund Actual Return		2.52	2.18	2.50	1.70

** Performance for Venture Capital is reported on a 3 to 4-month lag*
*** Benchmarks are for comparison purposes and do not correlate to the individual fund's benchmark returns.*

MANAGEMENT PERFORMANCE

The fund performance compared to the internal targets is made up of two components: management performance (manager effect) and asset allocation. The manager effect is a measure of how the individual managers performance compared to the performance of the benchmark and the asset allocation effect is the impact of a portfolio allocation being different from the target allocation.

PERA. As noted above PERA has beat its benchmark return for the quarter and the year. For the quarter, PERA's 22 basis points of superior performance is attributable to positive manager effect, which offset a slight negative asset allocation effect. For the year ending June 30th, manager effect is responsible for the majority of PERA's 112 basis points of superior performance, with international and domestic equity managers in particular doing well. The additional return from beating the benchmark return amounted to $115 million.

ERB. ERB's returns beat their fund benchmark return for the quarter but for the year, manager effect was responsible for about 75% of ERB's underperformance of 33 basis points, which equates to $24 million in forgone investment returns. Although externally managed domestic and international equity returns were strong, underperformance relative to benchmarks has hurt ERB's return. The internally managed REIT portfolio returns of 34 percent and TIP returns of 9 percent boosted ERB's returns.

SIC. The LGPF beat their benchmark return for the quarter and the year, with manager effect responsible for most outperformance. The 40 basis points of outperformance provided approximately $33 million in additional LGPF investment earnings The STPF lagged its target for both the quarter and the year, with asset allocation being a major factor in underperformance. The 50 basis points of amounted to $18 million in forgone returns.

Overall, SIC benefited from strong performance in the domestic and international equity areas, offsetting below average performance in the fixed income area, in particular high yield debt. Private equity returns of older investments in the national program have benefited the LGPF, while lower returns of newer investments (in particular in the NM program) have hurt the STPF. SIC has improved the performance of the internally managed large cap active account, earning 10.1 percent for the year. The internally managed index account matched the S&P 500 return of 6.3 percent for the year and the internally managed mid-cap account return of 13.8 percent lagged the 14.0 percent return of the S&P 400. Long term performance of the internally managed large cap active and large cap index accounts continue to lag fund benchmarks.

RISK PROFILES

Investors can gauge risk by looking at the standard deviation, which measures the funds' expected variability from the return. The higher the standard deviation, the higher the risk associated with that portfolio. Keep in mind that while diversification can reduce variability, the marginal benefit of additional diversification decreases after so many new securities (or different asset types) are added. At no point can risk be eliminated totally (i.e. market risk).

- The investment funds have had very similar risk profiles over the past ten years, though the permanent funds tend to have slightly higher standard deviations. ERB's risk profile has dropped, which they attribute to additional diversification from adding TIPS, REITs, and Hi-Yield bonds to their investment portfolio in the past year.

Table 4
Risk Profiles as shown by Standard Deviations

	ERB	PERA	LGPF	STPF
Last Year**	2.38	7.7	6.6	6.7
3 Year	6.11	9.6	8.5	8.6
5 Year	6.93	9.5	9.5	9.6
10 Year	7.26	9.6	9.5	9.5

* Standard deviation measures the fund's expected variability (deviation) from the expected return
** Due to the fact that one year standard deviation numbers include very few observations, SIC investment consultant recommends not placing a significant emphasis on these numbers.

CURRENT ISSUES

Investment Oversight Given Scandal at State Treasurer

In September 2005 the elected State Treasurer of New Mexico, who manages approximately $4 billion in short term investments (up to 3 years maturity) for the state as well as many local governments, was indicted for taking kickbacks from investment brokers. In addition to the federal charges, the State Treasurer likely faces an impeachment hearing in the New Mexico House of Representatives during the last week of October. While there is no evidence to date that any invested funds (including minimal amounts held by the Treasurer for ERB, PERA, and SIC) have been endangered, these recent events have led to increased scrutiny of all agencies that invest funds. A number of steps are being taken which include:

- The Department of Finance and Administration is undertaking a special audit of all Treasurer financial practices, investment activity and compliance with the Treasurer's investment policies and statutes. An initial update on this review is planned for late November.
- The State Permanent Fund Task Force (SPFTF) is a bi-partisan committee of legislators which studies investment and actuarial issues relating to NM's investing agencies and sponsors investment related legislation. Recent hearings have examined investment performance and agency procedures for procuring investment managers. Given these recent events, the SPFTF is planning a November hearing to examine how ERB, PERA, and SIC's governing boards provide oversight of investment policies and procedures.
- During the recent special legislative session in October 2005 the legislature appropriated $150,000 to support legislative oversight activities over the Office of the State Treasurer, as well as PERA, ERB, and SIC.

Update on Private Equity Program

The SIC appeared before the Legislative Finance Committee on August 10th in Farmington, NM to provide an update on their national and regional private equity investments. SIC's investment policy authorizes investment of up to six percent of the market value of the Land Grant Permanent Fund (LGPF) and the Severance Tax Permanent Fund (STPF) in private equity funds in a national program. The national program market value was $442 million at May 31, 2005, which is 3.7 percent of SIC assets. SIC is authorized by statute to invest up to six percent of the STPF in a private equity program that targets NM investments. The program market value was $74.2 million at May 31, 2005, which is two percent of STPF assets.

SIC reported that that as of March 31, 2005 SIC's New Mexico private equity investments of $71 million have helped bring in another $500 million in private equity investments in 24 New Mexico companies. Approximately 1,016 jobs have been created with an average salary of $80 thousand. The NM Film office has reported that NM film incentives, including SIC's film loan program, have generated over $200 million in film related economic development.

LFC staff noted that judging investment performance of private equity in the short term is difficult. Private equity returns often resemble a "J curve", with negative returns during the early years of the investment and positive returns in the out-years. The STPF national private equity program, which has been making investments since the 1980's has an internal rate of return (IRR) of 30.3 percent, while the STPF NM program, with more recent investments in NM funds, has a negative IRR of -12.5 percent. LFC staff had the following recommendations to improve the usefulness of SIC's reporting on private equity:

1) SIC should consider changing the format of their quarterly performance reporting of private equity to break out each individual component of the private equity programs so that both the full SIC board and members of the public can better understand how SIC is performing.

2) Since initial negative returns are typical for private equity funds, SIC should examine how other pension funds and endowments deal with reporting private equity returns and perhaps develop a report that stratifies fund performance based on the age of the fund.

3) SIC has committed to invest over a billion dollars in approximately 115 separate national fund and 20 separate NM funds. However, cash drawdowns of these commitments take multiple years as they are dependent on the individual funds finding worthy investments. SIC should consider developing performance metrics that will allow policymakers to judge whether or not investment managers are performing adequately in their attempts to find investments, and consider developing criteria on when investments should be terminated in order to put SIC funds to better use elsewhere.